DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 06-0394
FINANCIAL INSTITUTIONS TAX
For 2002, 2003, and 2004

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ISSUES

I. Applicability of the Financial Institutions Tax.

Authority: *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977); IC § 6-5.5-1-12, IC § 6-5.5-1-13; IC § 6-5.5-1-17(a); IC § 6-5.5-1-17(d)(2)(C); IC § 6-5.5-2-1(a); IC § 6-5.5-2-3; IC § 6-5.5-2-4; IC § 6-5.5-3-1(6); IC § 6-5.5-4-8.

Taxpayer argues that the assessment of Financial Institutions Tax is unconstitutional on the ground taxpayer does not have "substantial nexus" with Indiana.

II. Ten-Percent Penalty.

Authority: IC § 6-8.1-10-2.1; IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer states that it is entitled to abatement of the ten-percent penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state subsidiary of a clothing retailer which conducts business in multiple states. The clothing retailer decided to issue a "captive credit card" by means of a proprietary national credit card bank.

The clothing retailer's national credit card bank held the credit card receivables for one day "in order to alleviate burdensome capitalization requirements imposed by the [Competitive Equality Banking Act of 1987] . . . ." Taxpayer was formed to purchase the credit card receivables on a daily basis. During April 2000, the clothing retailer "contributed all of its receivables and certain fixed assets to [taxpayer]."

Taxpayer admits that it "engages in the maintenance and management of its credit card receivables portfolio" and that it "possesses all of the incidences of ownership of the receivables including the risk of bad debts that may be associated with the receivables."

Taxpayer states that its operations are conducted from leased office space located in Rhode Island. Taxpayer has 20 employees who work exclusively at the Rhode Island location.

In July 2006, the Department of Revenue (Department) conducted an audit review of taxpayer's business records. The audit found that taxpayer was a "non-filer for Indiana Financial Institutions Tax" (FIT) but determined that taxpayer was subject to FIT. Based upon taxpayer's income derived from Indiana credit card customers, the audit concluded that taxpayer owed FIT and issued proposed assessments for 2002, 2003, and 2004.

Taxpayer disagreed with the assessments and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer explained the basis for its protest. This Letter of Findings results.

I. Applicability of the Financial Institutions Tax.

DISCUSSION

Taxpayer admits that it meets the statutory standards of a Financial Institution pursuant to IC § 6-5.5-1-17(d) but argues that its activities do not create a "substantial presence" in Indiana. Taxpayer argues that the loan balances owned by its Indiana customers are "intangible balances that are situsedin Rhode Island."

Taxpayer concludes that IC § 6-5.5-1-17 "violates the Commerce Clause of the United States Constitution." (U.S. Const. art. I, § 8).

Within Indiana, "There is imposed on each taxpayer a franchise tax measured by the taxpayer's apportioned income for the privilege of exercising its franchise or the corporate privilege of transacting the business of a financial institution in Indiana." IC § 6-5.5-2-1(a).

For purposes of the FIT, a "'[t]axpayer' means a corporation that is transacting the business of a financial institution, including any of the following:

> (1) A holding company.
> (2) A regulated financial corporation.
> (3) A subsidiary of a holding company or regulated financial corporation.
> (4) Any other corporation organized under the laws of the United States, this state, another taxing jurisdiction, or a foreign government that is carrying on the business of a financial institution." IC § 6-5.5-1-17(a).

For purposes of the FIT, the "business of a financial institution" includes "Operating a credit card, debit card, charge card, or similar business." IC § 6-5.5-1-17(d)(2)(C).

The FIT is imposed on both "nonresident taxpayers" and "resident taxpayers" transacting business within this state. IC § 6-5.5-1-12, 13. The statute defines a "nonresident taxpayer" as "a taxpayer that (1) is transacting business within Indiana as provided in IC 6-5.5-3; and (2) has its commercial domicile outside Indiana." IC § 6-5.5-1-12. A taxpayer, not filing a combined return, determines its FIT liability based on the taxpayer's adjusted gross income "multiplied by the quotient of . . . the taxpayer's total receipts attributable to transacting business in Indiana, as determined under IC 6-5.5-4; divided by . . . the taxpayer's total receipts attributable to

transacting business in all taxing jurisdictions as determined under IC 6-5.5-4." IC § 6-5.5-2-3. In contrast, a taxpayer filing a combined return determines its FIT liability based on its apportioned income consisting of the taxpayer's "(1) the aggregate adjusted gross income, from whatever source derived, of the members of the unitary group; multiplied by . . . the quotient of . . . all the receipts of the taxpayer members of the unitary group that are attributable to transacting business in Indiana; divided by . . . the receipts of all the members of the unitary group from transacting business in all taxing jurisdictions." IC § 6-5.5-2-4.

The FIT definition of "transacting business" within this state includes the activities of a company which "regularly engages in transactions with customers in Indiana that involve intangible property, including loans . . . [that] result in receipts flowing to the taxpayer from within Indiana." IC § 6-5.5-3-1(6).

The statutory provision for attributing credit card receipts derived from customers both inside and outside Indiana is set out at IC § 6-5.5-4-8 which states as follows:

> Interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertaining credit card receivables and credit card holders' fees must be attributed to the state to which the card charges and fees are regularly billed.

Taxpayer challenges the FIT assessment on the ground that it does not have a substantial nexus with Indiana. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Supreme Court stated that a tax will not be deemed to interfere with interstate commerce when the tax is "applied to an activity with a substantial nexus within the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Id*. at 279. Taxpayer's protest is based on the assertion that it does not have the minimum connection with the state necessary to establish the requisite "substantial nexus."

To the extent taxpayer maintains that Indiana's FIT is – on its face – inapplicable, the Department must disagree. Under IC § 6-5.5-3-1, IC § 6-5.5-1-12, and IC § 6-5.5-1-17, taxpayer falls squarely within the definition of a non-resident entity conducting the business of a financial institution within this state; consequently, taxpayer is liable for FIT on the credit card income derived from customers within Indiana pursuant to IC § 6-5.5-4-8.

To the extent taxpayer facially challenges the constitutionality of the FIT as applied to non-resident businesses having only an economic nexus with Indiana, the Department declines to address the question raised because the Department does not have the authority to determine questions of a constitutional dimension.

FINDING

Taxpayer's protest is respectfully denied.

II. Ten-Percent Penalty.

DISCUSSION

Taxpayer requests that the Department exercise its discretion to abate the ten-percent negligence penalty.

IC § 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer did not file FIT tax returns, was audited during 2006, and was assessed for three years of unpaid taxes. Taxpayer is a substantial, sophisticated business receiving significant amounts of money from sources within Indiana. Taxpayer's larger constitutional question aside, the decision to ignore its actual or potential liability under the state's FIT is not the evidence of the "ordinary business care and prudence" expected of an "ordinary reasonable taxpayer" that would warrant abatement of the ten-percent negligence penalty.

FINDING

Taxpayer's protest is respectfully denied.

DK/JR/BLK – May 22, 2007.